Notes

Investment Bankers' Fairness Opinions in Corporate Control Transactions

Robert J. Giuffra, Jr.

In *Smith v. Van Gorkom*,[1] the Delaware Supreme Court held that the directors of Trans Union Corporation breached their fiduciary duty of care by approving a merger without adequate information on the fairness of the offered price of $55 per share.[2] Trans Union's directors, who relied solely on their chairman for the valuation of the transaction,[3] did not follow the common practice of asking an investment banker to render a fairness opinion.[4] The court suggested that, although fairness opinions were not required by law, the directors could have exercised an informed business judgment by obtaining such an opinion.[5] As one of the few cases imposing personal liability on the reputable directors of a major corpora-

1. 488 A.2d 858 (Del. 1985).

2. *Id.* at 874. The existence of a substantial premium over market value, without more information, did not provide an adequate basis for approving the transaction. *Id.* at 869 n.9 (offered price represented premium of 62% over average of Trans Union's high and low prices during previous nine months, and premium of 48% over last closing price).

3. *Id.* at 876–77. At the time of the directors' decision, no formal analysis (either in-house or outside) of Trans Union's value in an acquisition had been prepared. The chief financial officer's brief oral statement to the directors regarding the feasibility of a leveraged buyout did not constitute an adequate valuation study or "report" on which the directors could rely as defined by DEL. CODE ANN. tit. 8, § 141(e) (1983). *Van Gorkom*, 488 A.2d at 875.

4. Directors ask investment bankers to render fairness opinions in a wide variety of corporate control transactions. *See, e.g.*, Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264 (2d Cir. 1986) (lock-up option); Crouse-Hinds Co. v. Internorth, Inc., 634 F.2d 690 (2d Cir. 1980) (tender offer); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) (selective self-tender); Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983) (cashout merger); Kaplan v. Goldsamt, 380 A.2d 556 (Del. Ch. 1977) (share repurchase). For discussion of the role of fairness opinions in corporate control transactions, see Chazen, *Fairness From a Financial Point of View in Acquisitions of Public Companies: Is "Third-Party Sale Value" the Appropriate Standard?*, 36 BUS. LAW. 1439 (1981); Feuerstein, *Valuation and Fairness Opinions*, 32 BUS. LAW. 1337 (1977).

5. 488 A.2d at 876.

tion in the absence of fraud or wrongdoing,[6] *Van Gorkom* has placed new importance on obtaining fairness opinions.[7]

A fairness opinion is a judgment by an investment banker as to the financial fairness of the terms of a corporate control transaction.[8] In theory, such opinions should protect shareholder interests.[9] Fairness opinions have been criticized, however, as expensive rubber stamps that insulate directors from liability.[10] By hiring investment bankers, directors essen-

6. "The search for cases in which directors of industrial organizations have been held liable in derivative suits for negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack." Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099 (1968). Professor Bishop found only four such cases. *Id.* at 1099–1100. The American Law Institute draft report on corporate governance added only two cases to this list. PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS § 4.01, at n.17 (Tent. Draft No. 4, 1985).

7. *See* Fischel, *The Business Judgment Rule and the* Trans Union *Case*, 40 BUS. LAW. 1437, 1453 (1985) ("most immediate effect of [*Van Gorkom*] will be that no firm considering a fundamental corporate change will do so without obtaining a fairness letter or other similar documentation from outside consultants"). Commentators have been critical of the *Van Gorkom* decision. *See, e.g.*, Herzel & Katz, Smith v. Van Gorkom*: The Business of Judging Business Judgment*, 41 BUS. LAW. 1187 (1986); Manning, *Reflections and Practical Tips on Life in the Boardroom After* Van Gorkom, 41 BUS. LAW. 1 (1985). Professor Fischel has argued:

> Shareholders are the biggest losers after [*Van Gorkom*]. Firms will have no difficulty finding an "expert" who is willing to state that a price at a significant premium over the market price in an arm's length transaction is "fair.". . . [T]he cost of obtaining such an opinion is, in effect, a judicially imposed tax on fundamental corporate changes. The inevitable consequence will be that fewer transactions will occur and that when they do occur, returns to investors will be lower.

Fischel, *supra*, at 1453.

8. The following is an example of a fairness opinion:

> You have asked Lehman Brothers Kuhn Loeb Incorporated to give its opinion with respect to the proposed tender offer for all of the common shares of Rowan Companies, Inc. ("Rowan") at $26 per share.
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> In the time available to us, we have not had the opportunity to conduct a complete investigation of Rowan nor make any physical inspection of its facilities but we have been Rowan's investment banker since 1967 and have detailed knowledge of Rowan. . . . We have recently met with Rowan management . . . . We have reviewed certain available public information concerning Rowan, the record of public trading of Rowan's stock as compared with companies deemed comparable, and have made a general financial and statistical comparison of Rowan with selected public companies in the same or similar businesses. In addition, we have reviewed the prices and premiums of selected cash tender offers, including recent acquisitions of contract drilling companies. We think that our investigation is an adequate basis for our opinion expressed below.
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> Based upon the procedures we have conducted to date and our experience as investment bankers to the drilling industry, it is our opinion that the price of the proposed tender offer does not adequately reflect the value of Rowan.

Letter from Lehman Brothers Kuhn Loeb Inc. to the Board of Directors of Rowan Companies, Inc. (June 15, 1978), *reprinted in* 2 M. LIPTON & E. STEINBERGER, TAKEOVERS AND FREEZEOUTS N-10 (1978).

9. When rendering fairness opinions, investment bankers can serve as "gatekeepers." Gatekeepers are third parties who can obstruct misconduct by withholding a specialized good or service. For discussion of the costs and benefits of gatekeeper liability, see Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857 (1984) [hereinafter Kraakman, *Corporate Liability Strategies*]; Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53 (1986) [hereinafter Kraakman, *Gatekeepers*].

10. Former SEC Commissioner Bevis Longstreth argues that fairness opinions are often "boilerplated passkeys . . . effective in protecting a conflicted management from successful attack, but inade-

tially can delegate their fiduciary duty of care to an outsider, who does not owe the same duty to shareholders.[11] As a result, directors may rely on incomplete or misleading fairness opinions to pursue takeovers damaging shareholders' interests or to oppose transactions benefiting shareholders.[12] The problem, simply put, is that courts have neither closely examined directors' reliance on fairness opinions nor held investment bankers liable for negligence in rendering opinions.[13]

This Note argues that properly conducted fairness opinions can reduce opportunistic behavior by management[14] in corporate control transactions. After describing fairness opinions and their current legal status, the Note explains why fairness opinions sometimes do not serve shareholder interests. The Note then advocates (1) stricter judicial scrutiny of directors' reliance on fairness opinions, and (2) judicial recognition of the duty of investment bankers to act with care when rendering opinions. Finally, the Note sets forth procedural standards that courts could apply to determine whether directors or investment bankers have breached their respective duties of care to a corporation or its shareholders.

I. THE PROBLEM

A. *Background of Fairness Opinions*

The heightened level of merger and acquisition activity over the past ten years[15] has increased the role of investment bankers in corporate deci-

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quate to give shareholders full value for their shares." *Longstreth Says Federal, State Laws Are Not Assuring Fairness in Buyouts*, 15 Sec. Reg. & L. Rep. (BNA) 1908, 1909 (1983); *see also* Stein, *Investment Banking's Dirty Little Secret*, N.Y. Times, June 8, 1986, § 3 (Business), at 2, col. 3 (fairness opinions are "deceit upon the investing public and upon the marketplace generally, and certainly unworthy of institutions with serious national responsibilities and trust").

11. Courts have not found that an investment bank rendering a fairness opinion owes a fiduciary duty to shareholders. *See infra* note 94. Courts have held, however, that directors can discharge their fiduciary duty by hiring an investment banker. *See infra* note 74.

12. This problem is believed to be particularly acute in going-private transactions involving management. In 1983, for example, the management of Stokley-Van Camp proposed a cash buyout of all public shareholders. Management offered $55 per share, along with a statement from an investment bank that this price was "fair and attractive." Once management's offer became public, Quaker Oats made a successful bid for $77 per share. This third party bid could not be blocked because management controlled only 27% of Stokley's outstanding shares. Many going-private transactions, however, succeed before third parties can make higher bids. *See* McGough, *Fairness for Hire*, FORBES, July 29, 1985, at 52; *Longstreth Says Federal, State Laws Are Not Assuring Fairness in Buyouts*, *supra* note 10, at 1909.

13. Directors have not been found personally liable for relying on a negligently prepared fairness opinion. In a few cases, courts have enjoined the actions of directors relying on such opinions. *See infra* notes 84-85. There are no reported cases in which investment bankers have been held liable for negligence in the preparation of fairness opinions.

14. In this Note, "management" includes both inside (i.e., corporate officers who are also directors) and outside directors.

15. Although the number of mergers remained fairly constant from 1975 to 1985, the total dollar value paid in that period increased from $14 billion to $180 billion. The number of $100 million transactions rose from 14 to 270 during the same period; the number of $1 billion transactions in-

sionmaking. Investment bankers identify acquisition candidates, provide tactical advice to bidder and target firms, negotiate transactions, and prepare valuations of companies involved in transactions.[16] Fairness opinions are based on the results of such valuations. Typically, the investment banker will provide both a short written opinion stating whether the transaction is fair and more detailed statistical materials for use during the bankers' oral presentation to the board of directors.[17]

Firm valuation is essential in a transaction involving a closely held company, or a division or unit of a publicly held company. Without a large market for shares, investors need to construct a value for ownership of such assets.[18] In the case of a publicly held company, however, capital markets theory posits that the market price of shares is the "best" estimate, given publicly available information, of their value.[19] Nevertheless, acquirors have been willing to pay substantial premiums for the shares of target companies.[20] Commentators have proposed a number of explanations for mergers and tender offers at a premium over market price, including the removal of inefficient managers, "synergy" gains from the combination of two firms, inefficiencies in the capital markets, "empire building," and tax benefits.[21] The purpose of valuations of publicly held companies, therefore, is to determine the difference between the market price of a company's shares and the value of the shares in a transaction where corporate control is being sold.[22]

Fairness opinions serve two purposes. First, they assist and justify the decisionmaking of directors. If a hostile acquiror makes a bid for a company, for example, the target's directors will often seek a fairness opinion

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creased from one in 1975 to 36 in 1985. W.T. GRIMM & CO., MERGERSTAT REVIEW 1985, at 9 (1986).

16. *See* Greenhill, *Structuring an Offer*, 32 BUS. LAW. 1305, 1305-06 (1977) (discussing investment bankers' role in hostile tender offer).

17. *See* Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 124-27 (1979) (describing investment bankers' role at meeting of target's directors).

18. Harris, *Determining the Right Price to Pay*, in HANDBOOK OF MERGERS, ACQUISITIONS & BUYOUTS 149-51 (S. Lee & R. Colman eds. 1981).

19. *See, e.g.*, Gilson & Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984); Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970).

20. One study computed that the average premium in a successful tender offer (based on market price two months prior to the offer's announcement) was 49%. Bradley, *Interfirm Tender Offers and the Market for Corporate Control*, 53 J. BUS. 345 (1980). Statistics compiled by W.T. Grimm & Co. show that the median premiums paid on public tender offers between 1980 and 1985 ranged from 28% and 45%, based on the closing market price for the company's stock five business days prior to the announcement of the offer. W.T. GRIMM & CO., *supra* note 15, at 121.

21. *See* Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1163-75 (1984).

22. *See* Hazen, *Premiums in the Sale of Corporate Control*, 11 INST. ON SEC. REG. 317, 320 (1980) (valuation analysis determines size of "reasonable premium" for control).

before recommending a course of action.[23] A transaction's completion sometimes is made contingent upon an investment banker's willingness to provide a fairness opinion.[24] The rendering of a fairness opinion does not ensure, however, that the shareholders' interests will be protected. Investment bankers may have an incentive to craft their opinions in misleading ways or to follow valuation techniques that predispose results.[25] Similarly, self-interested directors may "shop" for a compliant investment banker.[26]

The second use of fairness opinions is to persuade shareholders to tender their shares or to approve the terms of a merger. Often, management will include an opinion as to the adequacy of the offered price in tender offer or proxy materials.[27] This representation by an investment bank can have a substantial impact on the shareholders' decision.[28] An improperly prepared fairness opinion can cause shareholders to tender their shares or to approve a merger that they would not otherwise approve.[29]

The "fairness" of the consideration offered in a merger or tender offer is both a legal and financial question.[30] When rendering fairness opinions, investment bankers evaluate the financial fairness of transactions, namely, would a rational buyer and seller, assuming that each had knowledge of relevant facts, purchase or sell the shares in question at the offered

23. *See* ABA Committee on Corporate Laws, *Guidelines for Directors: Planning for and Responding to Unsolicited Tender Offers*, 41 BUS. LAW. 209, 218 (1985).

24. *See Citadel's Refusal to Accept Salomon Fairness Opinion Leads to Lawsuit; Sudden Exit for Citadel's Shuffling Director*, CORP. CONTROL ALERT, Oct. 1985, at 1 (directors called off transaction when investment banker refused to give an opinion with same wording as required in merger agreement).

25. For example, slightly different estimates of firm earnings or changes in the capitalization rate applied to such earnings can produce significantly different results. *See* Fischel, *The Appraisal Remedy in Corporate Law*, 1983 AM. B. FOUND. RES. J. 875, 890-93 (discussing uncertainties of valuation).

26. *See* Kraakman, *Gatekeepers*, *supra* note 9, at 72-74 (examining problem of opinion shopping for third-party monitors).

27. *See* J. FREUND, ANATOMY OF A MERGER: STRATEGIES AND TECHNIQUES FOR NEGOTIATING CORPORATE ACQUISITIONS 470 (1975) (recommending inclusion of fairness opinion in proxy materials).

28. *See, e.g.*, Denison Mines, Ltd. v. Fibreboard Corp., 388 F. Supp. 812, 821 (D. Del. 1974) (fairness opinion in proxy statement "added persuasive support" for transaction supported by management); Joseph v. Shell Oil Co., 482 A.2d 335, 341 (Del. Ch. 1984) ("a primary purpose" of fairness opinion "was to convince the stockholders . . . that the price offered was fair"); *see also* Wander, *Special Problems of Acquisition Disclosure: Investment Bankers' Reports and Conflicts of Interest*, 7 INST. ON SEC. REG. 157, 158 (1976) (reporting that fairness opinions can influence shareholders' vote).

29. In Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983), for example, Lehman Brothers opined that $21 per share was a fair price in Signal Companies' cashout merger of UOP's minority shareholders. Although Lehman's opinion was included in the proxy statement sent to UOP's shareholders, the proxy did not disclose a valuation study prepared by Signal indicating the shares were worth up to $24 each. *Id.* at 712. As the court noted: "Since this [information] would have meant over $17,000,000 more to the minority, we cannot conclude that the shareholder vote was an informed one." *Id.*

30. *See* Feuerstein, *supra* note 4, at 1337-38.

price.[31] Modern valuation techniques do not permit an investment banker to determine whether a price is fair with absolute precision. A fair price is not the highest value attainable for the firm or a single value but a range of reasonable values.[32] Investment bankers also may characterize transactions in terms of "adequacy." Such an opinion can facilitate the adoption of defensive tactics by the management of target firms. If, for example, management wishes to resist a tender offer, and the investment banker believes a higher price can be obtained, the banker might opine that the offered price is inadequate, even though it is within the range of fairness.[33]

No federal or state law explicitly requires that investment bankers be asked to render fairness opinions in corporate control transactions. In going-private transactions, however, Securities and Exchange Commission Rule 13e-3[34] requires issuers to state whether the transaction is fair or unfair to unaffiliated security holders and to disclose any fairness opinions prepared by investment bankers.[35] State fiduciary duty law requires that directors consider some valuation information before acting on a transaction,[36] although *Van Gorkom* has left unsettled exactly what procedures should be followed.[37] A number of courts have held that directors can

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31. *See* Nathan & Shapiro, *Legal Standard of Fairness of Merger Terms Under Delaware Law*, 2 DEL. J. CORP. L. 44, 48 (1977); *see also* Chazen, *supra* note 4, at 1443-50 (suggesting measures of financial fairness in going-private transactions and arm's length mergers).

32. *See* Chazen, Friedman & Feuerstein, *Premiums and Liquidation Values: Their Effect on the Fairness of an Acquisition*, 11 INST. ON SEC. REG. 143, 147 (1980) (investment banker simply gives "judgment as to whether the deal is within the range that a sensible, prudent board would accept"). The possibility that other prospective purchasers or harder bargaining might result in a higher price makes it impossible for an investment banker to opine that the offered price is the highest attainable. *See* Chazen, *supra* note 4, at 1454.

33. *See* Weiss, *The Law of Take Out Mergers:* Weinberger v. UOP, Inc. *Ushers in Phase Six*, 4 CARDOZO L. REV. 245, 256 (1983).

34. 17 C.F.R. § 240.13e-3 (1985).

35. *See* SEC Schedule 13E-3, Items 8 & 9, 17 C.F.R. § 240.13e-100 (1985). There are three kinds of going-private transactions: (1) the second step in an acquisition that commenced in a tender offer; (2) the elimination of the minority interest in an existing subsidiary of a public corporation; and (3) a "pure" going-private transaction by which an insider takes a company private. *See* Brudney & Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354, 1356 (1978). Rule 13e-3 exempts second-step transactions occurring within one year of the earlier tender offer transaction if the consideration offered in the second step is at least equal to the highest consideration offered in the tender offer. 17 C.F.R. § 240.13e-3(g)(1) (1985). For a discussion of compliance with SEC Rule 13e-3, see A. BORDEN, GOING PRIVATE §§ 10.01-12.21 (1982).

36. *See* Consolidated Amusement Co. v. Rugoff, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,584, at 94,484 (S.D.N.Y. Oct. 6, 1978) (failure to consult investment banker one factor cited by court in finding that stock issuance was improper defensive tactic); Doyle v. Union Ins. Co., 202 Neb. 599, 277 N.W.2d 36 (1979) (holding directors who approved sale of company without obtaining valuation personally liable for $2.5 million in damages); *cf.* Panter v. Marshall Field & Co., 646 F.2d 271, 307 n.15 (7th Cir.) (Cudahy, J., concurring in part and dissenting in part) (suggesting that directors should have asked investment bankers to evaluate adequacy of tender offer), *cert. denied*, 454 U.S. 1092 (1981).

37. As the *Van Gorkom* court noted:

> We do not imply that an outside valuation study is essential to support an informed business judgment; nor do we state that fairness opinions by independent investment bankers are re-

fulfill their fiduciary duty of care by relying in good faith on fairness opinions,[38] and leading attorneys advise that directors seek a fairness opinion before acting on a merger or tender offer.[39]

B. *The Promise of Fairness Opinions: Reducing Agency Costs*

In the modern corporation, diversified shareholders entrust the operation of the firm to managers. But unless these managers also own the firm, their interests will diverge from those of the shareholders.[40] As a result, shareholders incur agency costs,[41] which include the costs of monitoring and restricting management behavior as well as the lost profits caused by managers' opportunism.[42]

Opportunistic behavior by managers is most likely during tender offers, mergers and other transactions for corporate control. For example, managers who believe that a successful takeover will lead to their replacement may engage in defensive tactics,[43] even if the takeover would be beneficial

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> quired as a matter of law. Often insiders familiar with the business of a going concern are in a better position than are outsiders to gather relevant information; and under appropriate circumstances, such directors may be fully protected in relying in good faith upon the valuation reports of their management.

488 A.2d at 876. The American Bar Association's Committee on Corporate Laws recommends that directors consider:

> the financial aspects of the offer, that is, not only the present and historical market value of the corporation's shares and the premiums paid in other relevant transactions, but also the liquidation and breakup values of the corporation's assets and component operations, where relevant, the prospects of the corporation, and (to the extent estimable) its stock on a going-concern basis over the next several years.

ABA Committee on Corporate Laws, *supra* note 23, at 218.

38. *See* cases cited *infra* note 74.

39. *See, e.g.*, Lipton, *supra* note 17, at 121-22.

40. *See* A. Berle & G. Means, The Modern Corporation and Private Property 116 (rev. ed. 1968) ("[W]here the bulk of the profits of enterprise are scheduled to go to owners who are individuals other than those in control, the interests of the latter are as likely as not to be at variance with those of ownership and . . . the controlling group is in a position to serve its own interests").

41. The term "agency costs" was introduced in Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305, 308 (1976).

42. Mechanisms for monitoring managers include: (1) market controls (i.e., employment, product, capital, and corporate control), *see* R. Winter, Government and The Corporation 16-20 (1978); (2) legal controls (e.g., fiduciary duties), *see* Easterbrook & Fischel, *Corporate Control Transactions*, 91 Yale L.J. 698, 702 (1982); (3) organizational controls (e.g., outside directors, accountants, investment bankers), *see* Fama & Jensen, *Separation of Ownership and Control*, 26 J.L. & Econ. 301, 312-15 (1983).

43. Fairness opinions can facilitate defensive tactics. Incumbent managers, faced with a merger proposal from a hostile bidder, can refuse to approve the transaction until an investment banker is consulted. This strategy is particularly effective after *Van Gorkom*. *See supra* notes 3-4 and accompanying text. An investment banker's opinion that a transaction is unfair may then justify defensive tactics. *See* cases cited *infra* note 74. A number of companies have proposed defensive charter amendments requiring that fairness opinions be obtained before approval of control transactions. *See, e.g.*, National Fuel Gas Co., Proxy Statement (Jan. 4, 1985) (charter amendment requiring inclusion of fairness opinion in proxy materials soliciting shareholder approval of control transaction); Brunswick Corp., Proxy Statement (Mar. 9, 1977) (charter amendment providing that terms of business combination with "substantial" shareholder must be found fair by two independent investment banks).

to shareholders.[44] Defensive tactics range from minor changes in the articles of incorporation to costly measures that can devastate a firm, such as selling off valuable assets or repurchasing shares at a substantial premium.[45] Conflicts of interest between managers and shareholders also occur on the acquiror's side of transactions. For example, managers may pursue unprofitable acquisitions to enhance their compensation, prestige and job security.[46] Moreover, when managers take firms private, their interests conflict directly with those of the shareholders.[47]

Fairness opinions rendered by investment bankers, if based on valuations following accepted procedures, can reduce the agency problem inherent in corporate control transactions. First, such opinions, like accountants' audits and lawyers' opinions, can serve a monitoring function for shareholders.[48] Experienced investment bankers, because they are outsiders with assets and reputations beyond the client firm and thus are more difficult to corrupt than inside managers, increase the confidence of and reduce the information costs to shareholders. Ideally, investment bankers diligently investigate a transaction's fairness using accepted valuation techniques and then offer their market reputations as "hostages" for the quality of their work.[49] Second, fairness opinions can limit the discretion and

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44. *See* Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1175 (1981) (managers have "substantial interest in preserving their company's independence and thus preserving their salaries and status"); Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 825 (1981) ("management can reject offers beneficial to shareholders to retain emoluments" of office).

45. For descriptions of the more common defensive tactics, see 1 A. FLEISCHER, TENDER OFFERS: DEFENSES, RESPONSES & PLANNING 291-387 (1983 & Supp. 1985); 1 M. LIPTON & E. STEINBERGER, TAKEOVERS & FREEZEOUTS 263-325 (1978).

46. *See* Mueller, *A Theory of Conglomerate Mergers*, 83 Q.J. ECON. 643, 644 (1969); Note, *The Conflict Between Managers and Shareholders in Diversifying Acquisitions: A Portfolio Theory Approach*, 88 YALE L.J. 1238, 1241-44 (1979). In a number of cases, shareholders in bidding firms have experienced large declines in stock values after a takeover bid. During the 1970's, oil companies were particularly poor acquirors. *See* Fisher, *The Decade's Worst Mergers*, FORTUNE, Apr. 30, 1984, at 262, 263, 266.

47. Professors Brudney and Chirelstein have proposed that going-private transactions involving management be prohibited, arguing that "the unavoidable suspicion is that the insiders will elect to go private at a moment in time that they perceive as a turning point in the company's affairs—but before that perception has become general. . . . The problem is compounded by the fact that, once a public market for the company's securities has been eliminated, no reliable basis remains for judging whether the ousted stockholders were fairly compensated for their interest." Brudney & Chirelstein, *supra* note 35, at 1368.

48. *See* Watts & Zimmerman, *Agency Problems, Auditing, and the Theory of the Firm: Some Evidence*, 26 J.L. & ECON. 613 (1983) (discussing historical importance of accountants' audit in minimizing agency costs); Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239, 288-93 (1984) (discussing role of lawyers' opinions in reducing shareholders' costs of verifying information in business transactions).

49. Leading investment banks command premium fees for rendering fairness opinions; investors trust the monitoring abilities of these investment banks and expect a bank's prospects for future premiums to deter carelessness or corruption. *Cf.* Gilson & Kraakman, *supra* note 19, at 613-21 (discussing role of investment banks as "reputational intermediaries" in initial public offerings). On the hostage strategy as a private enforcement device, see Williamson, *Credible Commitments: Using Hos-*

therefore the opportunistic behavior of managers.[50] In a hostile tender offer, for example, if the investment banker opines that a division of a firm is worth at least $100 million, the directors could not grant a lock-up option to a favored bidder for a lower amount.[51] In "freezeout" transactions, fairness opinions make it more difficult for the persons in control of an enterprise to deprive minority owners of a fair return on their investment.[52]

C. *The Failure of Market and Legal Controls*

Rather than reduce agency costs, fairness opinions can insulate managers from legal liability for actions taken in corporate control transactions. Existing market and legal controls do not ensure that fairness opinions are properly prepared by investment bankers or relied upon by directors.[53]

1. *Existing Market Controls*

The threat of injury to an investment bank's reputation is not sufficient to guarantee the quality of fairness opinions. In the absence of legal liability, investment banks rarely pay a reputational penalty for poorly prepared opinions. Shareholders cannot easily observe the quality of valuations.[54] At the same time, investment banks face strong incentives to

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tages to Support Exchanges, 73 AM. ECON. REV. 519 (1983).

50. In other corporate contexts, procedural mechanisms, such as special litigation committees, independent negotiating committees, and outside directors, are used to reduce management discretion. For a discussion of the proceduralization of corporate governance, see Hertzel & Colling, *Establishing Procedural Fairness in Squeeze-Out Mergers After* Weinberger v. UOP, 39 BUS. LAW. 1525, 1532-39 (1984).

51. *See, e.g.*, Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264, 279 (2d Cir. 1986) (decision to sell division for $70 million less than lowest estimate of firm's own investment banker evidence of breach of directors' duty of care); MacAndrews & Forbes Holdings v. Revlon, Inc., 501 A.2d 1239, 1249 (Del. Ch. 1985) (directors' decision to grant lock-up option at price $75 million below lowest estimate of value provided by Revlon's own investment banker did not "withstand hard analysis"), *aff'd*, 506 A.2d 185 (Del. 1986).

52. The terms "squeezeout," "cashout" or "takeout" are often used as synonyms for "freezeout." A freezeout transaction usually involves the elimination of minority shareholders from the business enterprise. For discussion of freezeout transactions, see F.H. O'NEIL & R. THOMPSON, O'NEIL'S OPPRESSION OF MINORITY SHAREHOLDERS §§ 5:01-5:36 (2d ed. 1985); Brudney & Chirelstein, *supra* note 35, at 1357-76. Shareholders who dissent from a freezeout transaction may require the corporation to purchase their shares at the "fair value" of the shares. *See, e.g.*, DEL. CODE ANN. tit. 8, § 262 (1983). On the limitations of the appraisal remedy, see Brudney & Chirelstein, *Fair Shares in Mergers and Take-Overs*, 88 HARV. L. REV. 297, 304-07 (1974).

53. *See, e.g.*, Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264, 275 (2d Cir. 1986) (court disapproved investment banker's "conclusory opinion"); Joseph v. Shell Oil Co., 482 A.2d 335, 344 (Del. Ch. 1984) (referring to "questionable methodology" and "quick and cursory" analysis, court concluded that "both the opinions of Morgan Stanley and of Goldman, Sachs leave something to be desired"); Weinberger v. UOP, Inc., 457 A.2d 701, 712 (Del. 1983) (court critical of "cursory preparation" of Lehman Brothers' fairness opinion).

54. In contrast, reputation is an effective signal when investment bankers underwrite securities. After the fact, investors can easily observe the quality of new issues by comparing the issue price with later market returns. *See* Gilson & Kraakman, *supra* note 19, at 619-20.

provide opinions that serve management's interests.[55] The investment bank often has an ongoing relationship with management and has structured the deal it is supposed to judge.[56]

When investment banks structure deals, the bulk of their compensation generally is contingent on the deal's success.[57] Thus, if an investment bank both structures a deal and prepares a fairness opinion, the bank faces a serious conflict of interest.[58] By opining that a deal is fair, the bank often stands to earn fees far in excess of the fee it has earned for the fairness opinion. If an investment bank brings an acquisition candidate to a firm, for example, the bank may have an incentive to overvalue the acquisition candidate's future earnings, overestimate synergies between the companies, and overlook problems in the board's financing plan.[59]

2. *Existing Legal Controls*

Under common law fraud, shareholders must demonstrate that directors and investment bankers knowingly misrepresented the contents of a fairness opinion to recover damages.[60] Similarly, SEC Rule 10b-5[61] prohibits

55. In *Weinberger*, a partner in Lehman Brothers, who was also a director of UOP, coordinated the investment bank's three-day review of UOP. One indication of Lehman's pliancy was the fact that, when the opinion was drafted, the price was left blank. At some point, "[e]ither during or immediately prior to the directors' meeting, the two-page 'fairness opinion letter' was typed in final form and the price of $21 per share inserted." 457 A.2d at 707. Similarly, in the cashout merger of Shell Oil by Royal Dutch, Morgan Stanley, hired by Royal Dutch, opined that the value of the minority shares was $53 per share. But Goldman, Sachs, hired by a special committee of six outside directors of Shell, valued the minority's shares at $80 to $85 per share. Joseph v. Shell Oil Co., 482 A.2d 335, 339 (Del. 1984).

56. *See* McGough, *supra* note 12, at 52 (reporting examples).

57. A typical agreement with an investment bank for providing services in a corporate control transaction consists of a base fee and a contingent fee. *See, e.g.*, Radol v. Thomas, 534 F. Supp. 1302, 1315 n.19 (S.D. Ohio 1982) (describing First Boston's fee for representing Marathon Oil in takeover by U.S. Steel). The bank generally will charge an additional flat fee for rendering a fairness opinion. In some cases, the bank will receive additional fees if the opinion is publicly distributed. *See, e.g.*, Anderson v. Boothe, 103 F.R.D. 430, 435 (D. Minn. 1984) (Salomon Brothers received $250,000 for opinion and additional $150,000 once it was made public). In going-private transactions, the investment bank hired by the outside directors sometimes will receive a fee based on a percentage of the amount paid to minority shareholders. *See Shell: Bankers' Feud Fuels Parent-Child Rift*, CORP. CONTROL ALERT, May 1984, at 1, 4 (Goldman, Sachs received a fee of $2 million plus 0.67% of any amount Royal Dutch paid over $55 per share in cashout of Shell). The purpose of such an arrangement is to give the investment bank an incentive to achieve a higher price for the minority shareholders.

58. *See, e.g.*, Radol v. Thomas, 103 F.R.D. 430, 436 (D. Minn. 1984) ("a contingent fee arrangement between a target company and its investment banker could have the potential to taint the fairness opinion of the investment banker").

59. *See, e.g.*, *Baldwin Sues Merrill Lynch, Is Sued by SEC*, Wall St. J., Sept. 27, 1985, at 8, col. 1 ($1.3 billion suit alleging that Merrill Lynch failed to disclose acquisition candidate's "true" financial prospects in fairness opinion).

60. *See, e.g.*, Richardson v. White, Weld & Co., [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,864, at 95,545 (S.D.N.Y. May 11, 1979) (liability may be imposed on investment banker for conspiring with dishonest fiduciary in issuance of fairness opinion); Laventhol, Krekstein, Horwath & Horwath v. Tuckman, 372 A.2d 168, 170 (Del. 1976) (accounting firm can be held liable for knowing participation in directors' breach of fiduciary duty of loyalty during merger).

fraudulent conduct in connection with the sale of a security, provided the defendants act with the requisite scienter (or knowledge).[62] Tender offers and going-private transactions are subject to antifraud rules comparable to Rule 10b-5, except that the unlawful conduct need not occur in connection with the sale of a security.[63] The SEC's proxy regulations proscribe false and misleading statements in proxy materials.[64] In order to establish director or investment banker liability under the proxy regulations, shareholders probably need to demonstrate scienter, although some courts have suggested that negligence is sufficient against inside directors.[65]

Plaintiff shareholders rarely, if ever, can prove that directors and investment bankers acted with scienter.[66] As a result, both common law

61. 17 C.F.R. § 240.10b-5 (1985).

62. *See, e.g.*, Helfant v. Louisiana & S. Life Ins. Co., 82 F.R.D. 53, 56 (E.D.N.Y. 1979) (allegation that investment bank issued opinion contained in proxy knowing that representation of share value was false stated claim under Rule 10b-5).

63. Section 14(e) of the Williams Act, 15 U.S.C. § 78n(e) (1982), prohibits fraudulent and deceptive practices in connection with tender offers. Similarly, Rule 13e-3, 17 C.F.R. § 240.13e-3 (1985), prohibits fraudulent and deceptive practices in connection with going-private transactions. *See, e.g.*, Radol v. Thomas, 534 F. Supp. 1302, 1308-09 (S.D. Ohio 1982) (court dismissed Section 14(e) and Rule 13e-3 claims, holding that plaintiffs failed to demonstrate that fairness opinion contained in tender offer materials was fraudulent). In an exchange offer, that is, an offer of securities rather than cash, directors and investment bankers may be liable under Section 11 of the 1933 Securities Act if a misleading fairness opinion is contained in a registration statement. Ch. 38, § 11, 48 Stat. 74, 82 (codified as amended at 15 U.S.C. § 77k (1982)). *See generally* McAtee, *The Role of the Dealer Manager in the Disclosure Process*, 32 Bus. Law. 1331 (1977) (discussing investment bankers' liability under federal securities laws in tender offers).

64. *See* 17 C.F.R. § 240.14a-9 (1985). Section 14(a) applies to any person, including a director, who solicits or permits the use of his or her name to solicit any proxy. 15 U.S.C. § 78(n)(a) (1982). Investment bankers can only be sued as aiders and abettors under 14a-9. Mendell v. Greenberg, [1985-86 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,218, at 91,611 (S.D.N.Y. July 12, 1985). The elements of a private cause of action for violation of Rule 14a-9 are: (1) that the proxy materials contained a false or misleading statement of material fact; (2) that the proxy solicitation was an essential link in effecting the proposed transaction; and (3) that the defendant acted with some level of culpability. Halpern v. Armstrong, 491 F. Supp. 365, 378 (S.D.N.Y. 1980).

65. While the Supreme Court has imposed a scienter requirement in an action under Rule 10b-5, *see* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), the issue remains unresolved in Rule 14a-9 actions. Where the defendant is the corporation, negligence probably suffices. *See* Gould v. American-Hawaiian S.S. Co., 535 F.2d 761, 777-78 (3d Cir. 1976). The Sixth Circuit, however, has held that scienter must be established in a suit against an accountant under Rule 10b-5 and strongly suggested that scienter be required in all 14a-9 suits. Adams v. Standard Knitting Mills, 623 F.2d 422, 428-30 (6th Cir.), *cert. denied*, 449 U.S. 1067 (1980). Similarly, the Second Circuit, in a pre-*Hochfelder* decision, intimated that scienter should apply to 14a-9 suits against outside directors. *See* Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1300-01 (2d Cir. 1973). In 14a-9 suits aginst investment bankers as aiders and abettors, scienter must be shown. *See* Armstrong v. McAlpin, 699 F.2d 79, 91 (2d Cir. 1983).

Courts have enjoined transactions for incomplete disclosure of the basis of a fairness opinion in proxy materials. *See, e.g.*, Kohn v. American Metal Climax, Inc., 458 F.2d 255, 268-69 (3d Cir. 1972) (failure to disclose that investment bankers relied on data supplied by management); Berkman v. Rust Craft Greeting Cards, Inc., 454 F. Supp. 787, 791-93 (S.D.N.Y. 1978) (failure to disclose investment banker's conflict of interest); Denison Mines, Ltd. v. Fibreboard Corp., 388 F. Supp. 812, 822 (D. Del. 1974) ("bare reference of the Proxy Statement to an opinion of an independent investment [banking] firm that a transaction was 'fair to the company and its stockholders' without further reference to the basis for that opinion was misleading").

66. *See, e.g.*, Mendell v. Greenberg, [1985-86 Transfer Binder] Fed. Sec. L. Rep. (CCH)

fraud and the federal securities laws do not provide sufficient deterrence to ensure the proper preparation of fairness opinions. Stricter judicial scrutiny of the reasonableness of directors' reliance on fairness opinions and judicial recognition of the duty of investment bankers to act with care when rendering opinions can serve two purposes. First, this approach will discourage fraudulent behavior that now goes unpunished. Second, such judicial action will deter ordinary negligence by directors and investment bankers.

II. Directors' Reliance on Fairness Opinions

Directors should be able to fulfill their duty of care only by relying on fairness opinions that are based on accepted valuation procedures. This requirement, implied in *Van Gorkom*,[67] will make directors more responsive to shareholder interests in corporate control transactions.

A. *The Duty of Care and the Business Judgment Rule*

Directors have a fiduciary obligation to perform their duties with reasonable care.[68] The business judgment rule affords directors broad discretion in devising business strategies.[69] The business judgment rule does not, however, protect all director actions taken in the absence of fraud or wrongdoing. Directors must act on an informed basis with due care and diligence.[70] When directors fail to act on an informed basis, their actions

¶ 92,218, at 91,611 (S.D.N.Y. July 12, 1985) ("Drexel [Burnham Lambert Inc.] cannot be sued as an aider and abettor [under Rule 14a-9], because plaintiff has failed to allege the requisite scienter."); Associated Imports, Inc. v. ASG Indus., No. 5953 (Del. Ch. June 20, 1984) (Lexis, States library, Del. file) (court not satisfied banker "knowingly" aided and abetted in breach of directors' fiduciary duty); Weinberger v. UOP, Inc., 426 A.2d 1333, 1348 (Del. Ch. 1981) ("Here, there is no evidence of any understanding or overt combination between Signal, UOP and Lehman Brothers to shortchange the interests of UOP's minority."), *rev'd on other grounds*, 457 A.2d 701 (Del. 1983). The Supreme Court has explicitly left open the question whether reckless behavior could satisfy the scienter requirement under the federal securities laws. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 n.12 (1976).

67. 488 A.2d at 877 ("directors were entitled to rely upon their chairman's opinion of value and adequacy, provided that such opinion was reached on a *sound basis*") (emphasis added); *see also* Pogostin v. Rice, 480 A.2d 619, 627 (Del. 1984) (directors' informed decision to reject tender offer supported by "[v]aluation studies, *carefully prepared* by outsiders") (emphasis added).

68. While most states have adopted statutes establishing a director's duty of care, Delaware courts imply this duty. *See* Cheff v. Mathes, 41 Del. Ch. 494, 503-05, 199 A.2d 548, 554-55 (Del. 1964).

69. Judge Winter argues that the business judgment rule serves several purposes. First, the rule encourages competent persons to assume directorships. Second, the rule keeps courts from becoming enmeshed in after-the-fact evaluations of corporate decisions. Third, the rule benefits diversified shareholders by encouraging risk-taking by directors. Joy v. North, 692 F.2d 880, 885-86 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983).

70. The business judgment rule raises a rebuttable presumption in favor of the correctness of the directors' decision; to succeed in challenging the directors' business judgment, the plaintiff shareholders must show that the directors had an interest in the transaction or that the decision was not made in good faith after a reasonable investigation. Treadway Cos. v. Care Corp., 638 F.2d 357, 382 (2d Cir. 1980).

may be enjoined; directors also may be personally liable to the corporation or its shareholders for monetary damages for breach of their fiduciary duty.[71] The standard for determining whether a decision was informed is gross negligence.[72] In applying the gross negligence standard, courts look to the extent of deliberation, the significance of the transaction to the fate of the company, and the quality of the information, including expert advice, relied upon by the directors.[73]

The business judgment rule ordinarily protects directors against charges of breach of fiduciary duty when an investment banker's advice has been obtained.[74] The directors' reliance on such advice, however, must be reasonable and in good faith. In other words, reliance is only one factor demonstrating the directors' good faith or exercise of due care; it is not an absolute defense. The directors still must consider the quality of the professional's advice.[75]

The application of the business judgment rule in corporate control transactions has been widely criticized.[76] The rule has been applied to

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71. A recent amendment to the Delaware Corporation Law enables corporations to adopt charter amendments limiting the personal liability of directors for monetary damages for duty of care violations. *See* 65 Del. Laws 289 (1986) (to be codified at DEL. CODE ANN. tit. 8, § 102(b)(7)) (effective July 1, 1986). The *Van Gorkom* decision, in part, was responsible for this amendment. *See* Lewin, *Delaware Law Allows Less Director Liability*, N.Y. Times, June 19, 1986, at D1, col. 1. Such charter provisions would have no effect on the availability of an injunction when directors breach their duty of care. A number of other states that have recently amended their corporation laws, including New York, have decided not to permit similar limitation of directors' personal liability. *See* 1986 N.Y. Laws ch. 513, §§ 721-27.

72. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

73. *See* Smith v. Van Gorkom, 488 A.2d 858, 874-78 (Del. 1985); Gimbel v. Signal Cos., 316 A.2d 599 (Del. Ch.) (directors sold oil reserves without updating valuation of price of oil), *aff'd*, 316 A.2d 619 (Del. 1974); Royal Indus. v. Monogram Indus., [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,863, at 91,131 (C.D. Cal. Nov. 29, 1976) (directors approved purchase of controlling interest in another company without obtaining pro forma financials).

74. *See, e.g.*, Treadway Cos. v. Care Corp., 638 F.2d 357, 384 (2d Cir. 1980) (defendant directors exercised reasonable judgment by engaging "an investment banking firm to help them to negotiate and help them evaluate proposed mergers" and asking for pro forma balance sheets); Crouse-Hinds Co. v. Internorth, Inc., 634 F.2d 690, 694 (2d Cir. 1980) (rejecting plaintiff's claim that directors acted in bad faith, and describing in detail defendants' discussion with and reliance upon financial analyst); Horwitz v. Southwest Forest Indus., 604 F. Supp. 1130, 1134 (D. Nev. 1985) (preliminary injunction against issuance of poison pill warrants denied, in part because directors relied on investment bankers); Treco, Inc. v. Land of Lincoln Sav. & Loan, 572 F. Supp. 1455, 1460 (N.D. Ill. 1983) (holding for defendant, court noted that since defendant had sought advice from representatives of Dean Witter Reynolds Inc., his investigation was "reasonable"); Anaconda Co. v. Crane Co., 411 F. Supp. 1210, 1215 (S.D.N.Y. 1975) (reliance on investment banker's report that offeror's price was too low justified defensive tactics); Cheff v. Mathes, 41 Del. Ch. 494, 199 A.2d 548 (Del. 1964) (reasonable investigation shown by reliance upon investment banker's recommendation favoring stock repurchase); Kaplan v. Goldsamt, 380 A.2d 556 (Del. Ch. 1977) (derivative suit alleging waste and breach of fiduciary duty in purchase of stock from former director dismissed, in part on evidence that defendants procured price estimates from two different financial analysts).

75. For a discussion of the limitations of the reliance defense, see Hawes & Sherrard, *Reliance on Advice of Counsel as a Defense in Corporate and Securities Cases*, 62 VA. L. REV. 1, 41-49 (1976).

76. *See* Easterbrook and Fischel, *supra* note 44, at 1198-99; Brudney, *Fiduciary Ideology in Transactions Affecting Corporate Control*, 65 MICH. L. REV. 259, 274 (1966) (noting "incongruity of applying a standard designed to vindicate the excercise of business judgment in non-conflict-of-

"clothe directors, battling blindly to fight off a threat to their control, with an almost irrebuttable presumption of sound business judgment, prevailing over everything but the elusive hobgoblins of fraud, bad faith or abuse of discretion."[77] A number of courts have begun to examine directors' actions more carefully in such transactions, although a consistent method of applying the business judgment rule has not been adopted.[78] Stricter judicial scrutiny of directors' reliance on fairness opinions is one possible approach to the agency problem inherent in corporate control transactions.

B. *A Procedural Standard of Care*

Courts risk encouraging management misconduct and "opinion shopping" unless they require directors to monitor investment bankers.[79] When directors rely on fairness opinions, they should have the following duties: (1) to select the investment banker with care; (2) to disclose accurate information to the investment banker; (3) to determine whether the investment banker followed accepted valuation procedures; and (4) to examine the investment banker's conclusions.

Directors should consider a number of factors to determine whether an investment banker is competent to render a fairness opinion. The investment banker generally should have expertise in modern valuation techniques and have experience preparing fairness opinions for reasonably comparable transactions.[80] In going-private transactions involving man-

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interest situations" when directors seek to retain control).

77. Panter v. Marshall Field & Co., 646 F.2d 271, 299 (7th Cir.) (Cudahy, J., concurring in part and dissenting in part), *cert. denied*, 454 U.S. 1092 (1981).

78. In Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985), the Delaware Supreme Court strictly applied the business judgment rule, stating that the determination of whether a business judgment is an "informed one" in a cashout merger turned on "whether the directors have informed themselves 'prior to making a business decision, of all material information reasonably available to them.' " *Id.* at 872 (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)). In Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985), the court, after noting the "omnipresent specter that a board may be acting in its own interests" in a takeover, *id.* at 954, held that "[i]f a defensive measure is to come within the ambit of the business judgment rule, it must be reasonable in relation to the threat posed." *Id.* at 955. Finally, in Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173 (Del. 1986), the court found that, once the directors proceeded on the assumption there would be a breakup of the company, their "role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company." *Id.* at 182; *see also* Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255 (2d Cir. 1984) (issuance of new shares and creation of ESOP for purpose of strengthening management control of company not entitled to broad protection of business judgment rule); Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264, 276 (2d Cir. 1986) (suggesting that directors have "*heightened* duty of care" when approving lock-up) (emphasis in original).

79. Stricter judicial scrutiny of directors' relationships with investment bankers is justified by the absence of other legal controls. For example, the SEC carefully monitors accountants, and requires directors to disclose "opinion shopping" in proxy materials. *See* Form 8-K, Item 4, 42 Fed. Reg. 4429, 4430 (1977); *see also* Regulation S-X, 17 C.F.R. § 210.2-01 (1983) (accountant must be independent "in fact"; non-audit ties between firm and client jeopardizes requisite independence).

80. *Cf.* Hawes & Sherrard, *supra* note 75, at 20-28 (discussing selection of competent legal counsel).

agement and other freezeout transactions, the special negotiating committee of disinterested directors should be required to hire a disinterested investment banker to represent shareholder interests.[81] Director reliance on in-house valuations or on the fairness opinion of the investment banker who structured the deal should be limited to arm's length transactions, such as a merger negotiated between two independent firms. In all transactions, directors should not enter into contingent fee arrangements that impeach an investment banker's independence.[82]

As investment bankers often rely on financial information provided by management in preparing fairness opinions, directors should be liable for the disclosure of erroneous information due to their bad faith or negligence.[83] This rule will promote greater diligence and caution by directors when they disclose information to investment bankers.

In a number of cases, courts have enjoined transactions in which directors relied on a poorly prepared fairness opinion.[84] Courts have not, how-

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81. In order to reduce the conflict of interest inherent in going-private transactions, directors often establish a special committee of disinterested directors to evaluate the transaction. In most cases, this committee hires a disinterested investment banker. *See* Friedman, Gordon & Brown, ***Representing the Public Company in a Going-Private Transaction***, in PRACTISING LAW INSTITUTE, GOING PRIVATE 1984, at 105, 108–112 (Corporate Law and Practice Course Handbook Series No. 453, 1984). The SEC has considered requiring that two indepedent investment bankers evaluate the consideration offered in going-private transactions, although such a regulation has not been adopted. *See* Notice of Public Fact-Finding Investigation and Rulemaking Proceeding in the Matter of "Going Private" Transactions by Public Companies or Their Affiliates, 40 Fed. Reg. 7947 (1975).

Courts or the SEC could require that directors only rely on fairness opinions prepared by disinterested investment bankers in *all* transactions. Although this approach might eliminate some conflicts of interest, it raises two problems. First, "disinterested" investment bankers may have received or hope to recieve business from either the company or the original investment banker. *Cf.* Kraakman, *Gatekeepers*, *supra* note 9, at 70–71 (discussing patronage as device for corrupting third-party monitors). Second, the hiring of another investment banker would increase information costs. These costs include the obvious cost of hiring a second investment banker, and the second banker's likely inability to prepare an opinion as quickly as the investment banker who structured the deal. These increased information costs are outweighed by the need for special procedural protections in going-private transactions. *See supra* note 47.

82. Contractual agreements providing for contingent compensation in the event of improved or white knight offers or use of the fairness opinion in a disclosure document do not impeach an investment banker's independence. 1 M. LIPTON & E. STEINBERGER, *supra* note 45, at 415–16.

83. *See* Joseph v. Shell Oil Co., 482 A.2d 335, 341 (Del. Ch. 1984) (directors breached fiduciary duty by failing to provide "essential information" on value of oil reserves to investment banker).

84. In Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264 (2d Cir. 1986), the Second Circuit held that the directors of SCM Corporation breached their duty of care by granting a lock-up option to a white knight without making a diligent inquiry into the value of the optioned assets or the value of the company as a whole. The directors, in a three-hour late-night meeting, were apparently content with their investment banker's conclusory opinion that the price of the option was within the range of fair value. The investment banker did not provide any financial data or a written opinion. Had the directors inquired, they would have learned the banker did not even investigate the range of fair value. *Id.* at 275. As the court held:

> [D]irectors have some oversight obligations to become reasonably familiar with an opinion, report, or other source of advice before becoming entitled to rely on it. . . . The proper exercise of due care by a director in informing himself of material information and in overseeing the outside advice on which he might appropriately rely is, of necessity, a pre-condition to performing his ultimate duty of acting in good faith to protect the best interests of the corporation.

ever, articulated what constitutes a fairness opinion upon which directors may rely. One court was critical of a fairness opinion prepared "virtually overnight and without the necessary time and deliberation for a fair evaluation . . . ."[85] This Note proposes that directors be able to rely only on fairness opinions that conform to accepted standards in the investment banking industry.[86] In an analogous context, courts have required directors to assure that accounting methods adhere to industry standards.[87]

The requirement that the directors examine the investment banker's conclusions as to a transaction's fairness is a reasonable one. There may be cases where a transaction is plainly unfair, even though the fairness opinion adheres to industry standards.[88] Under the business judgment rule, reliance on a properly prepared opinion is not in itself a complete

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Id. at 275-76. *But see id.* at 290-91 (Kearse, J., dissenting) (business judgment rule precludes judicial scrutiny of directors' good faith reliance on fairness opinion). In Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250 (7th Cir. 1986) (Posner, J.), where a target company was enjoined from enforcing a "poison pill" plan, the court was also critical of directors' reliance on a fairness opinion:

> [I]t is apparent that the insiders on the board . . . decided from the start to block the tender offer, before its ramifications for shareholder welfare were considered; judgment first, trial later, as the Queen of Hearts said in *Alice in Wonderland.* Smith Barney held itself out as a blocker, and would have lost its $75,000 bonus if it had advised the board that the tender offer was fair . . . . How the fairness of the tender offer could be determined without any consideration of the fairness of the offer price is mystifying.

Id. at 257. Finally, in Edelman v. Fruehauf Corp., No. 86-71332 (E.D. Mich. July 24, 1986), *aff'd*, 798 F.2d 882 (6th Cir. 1986), the district court enjoined a going-private transaction involving management, in part because the special committee of disinterested directors did not ask its investment banker to determine a range of values for the company.

85. Royal Indus. v. Monogram Indus., [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,863, at 91,139-40 (C.D. Cal. Nov. 29, 1976); *see also* EAC Indus. v. Frantz Mfg., No. 8003 (Del. Ch. June 28, 1985) (LEXIS, States library, Del. file) (enjoining the issuance of shares to ESOP, court held that directors could not rely on "improvised" fairness opinion). Courts have been favorably disposed towards fairness opinions based on thorough valuations. *See, e.g.*, Tanzer v. International Gen. Indus., 402 A.2d 382, 389 (Del. Ch. 1970) (price recommended by investment banker after visits to target's plants, discussions with management, valuation of comparable publicly traded companies, review of financial statements and other relevant factors was fair to minority in cashout merger).

86. The directors should not be strictly liable, however, when relying on a fairness opinion. If, for example, the investment banker makes a computational error that is not reasonably discoverable by the directors, the directors should escape liability. The benefits of strict liability (e.g., reduced enforcement costs) are outweighed by the greater costs of compliance that such liability imposes on firms. These compliance costs include compensating managers for bearing increased risk and the agency costs resulting from managerial overdeterrence. *See* Kraakman, *Corporate Liability Strategies, supra* note 9, at 887. For discussion of accepted techniques for preparing fairness opinions, see *infra* notes 104-108 and accompanying text.

87. *See* Francis v. United Jersey Bank, 87 N.J. 15, 32, 432 A.2d 814, 822 (1981); Lippitt v. Ashley, 89 Conn. 451, 465, 94 A. 995, 1000 (1915); *see also* ABA Committee on Corporate Laws, *Corporate Director's Guidebook*, 33 BUS. LAW. 1595, 1608 (1978) ("corporate director should be concerned with the establishment and maintenance of an effective [information] reporting system").

88. *See* Gimbel v. Signal Cos., 316 A.2d 599, 610 (Del. Ch.) (court ignored procedural regularity of transaction, noting that "[t]here are limits on the business judgment rule which fall short of intentional or inferred fraudulent misconduct and which are based simply on gross inadequacy of price"), *aff'd*, 316 A.2d 619 (Del. 1974).

and absolute defense. Directors still have an obligation to study independently the facts of a transaction before making a decision.[89]

III. Investment Bankers' Liability for Fairness Opinions

Investment bankers will not consistently follow proper procedures if liability for poorly prepared fairness opinions is placed solely on directors. Directors do not observe every act of their investment banker and therefore cannot require a given level of care. The imposition of liability also will make investment bankers more vigilant in their role as third-party monitors in corporate control transactions and make collusion between directors and bankers more difficult. Third-party monitoring is needed because director liability fails to ensure sufficient compliance with legal rules at an acceptable cost.[90]

A. *The Duty Owed by Investment Bankers*

When an investment bank is retained to render a fairness opinion, the contractual relationship should impose certain obligations on the bank, one of which is a duty to exercise reasonable care in accordance with the standards of the investment banking profession.[91] If the investment bank fails to exercise the degree of care required, the bank should be liable to either the client corporation, the client corporation's shareholders or both for breach of contract or for negligence.

The cause of action available to the client corporation's shareholders depends on how the fairness opinion was used. If the opinion was used to persuade shareholders to tender their shares or to approve a merger, shareholders should have both a derivative and direct action against the bank.[92] In analogous circumstances, courts have held accountants directly

89. Investment bankers are sometimes no better equipped to form an opinion as to the fairness of a transaction than are the directors, particularly in transactions involving companies with substantial intangible assets, e.g., patents and trademarks, technological information and other proprietary information.

90. There will be increased justification for investment banker liabilty if many corporations adopt charter provisions limiting director liability for duty of care violations pursuant to Del. Code Ann. tit. 8, § 102(b)(7). *Cf.* Kraakman, *Corporate Liability Strategies*, *supra* note 9, at 888-90 (discussing third-party monitoring as remedy for enforcement insufficiency).

91. Absent agreement, courts often supply a contractual term imposing a duty of "best" or "reasonable" efforts on professionals. *See, e.g.*, Wright v. Williams, 47 Cal. App. 3d 802, 810, 121 Cal. Rptr. 194, 199 (1975) (maritime lawyer "must exercise the skill, prudence and diligence exercised by other specialists of ordinary skill and capacity specializing in the same field"); Dantzler Lumber & Export Co. v. Columbia Casualty Co., 115 Fla. 541, 547-48, 156 So. 116, 118 (1934) ("Public accountants and auditors hold themselves out to be skilled and competent to perform the duties and services which they undertake to perform as accountants and auditors and they are bound in law to perform such services in an accurate and skillful manner.").

92. *See generally* W. Cary & M. Eisenberg, Cases and Materials on Corporations 896-99 (5th ed. 1980) (discussing distinction between derivative and direct actions). The determination of whether a shareholder's suit is derivative or direct has important procedural consequences.

liable for negligent misrepresentation to third parties such as shareholders.[93]

If, on the other hand, the fairness opinion was relied upon only by the directors in their decisionmaking, the shareholders may be limited to a derivative action on the client corporation's behalf.[94] Courts could, however, interpret the contractual term "client of the investment bank" to include both the corporation and its shareholders even though the bank and the shareholders are not in "privity" of contract.[95] This approach would ensure that directors could not shift their duty of care to a party who does not owe a similar duty to the shareholders.[96]

Derivative suits are subject to complex rules involving standing, security for expenses, demand on the directors, and demand on the shareholders. *See* Coffee & Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 309-15 (1981).

93. Section 552 of the Restatement (Second) of Torts states that a professional person is liable for negligent misrepresentation when failing to excercise reasonable care in obtaining or communicating information. This liability is limited to the loss suffered by those persons for whose benefit and guidance the information is supplied, and to those third persons who the professional knows will be relying upon the information. RESTATEMENT (SECOND) OF TORTS § 552 (1977). *See, e.g.*, Larsen v. United Fed. Sav. & Loan Ass'n, 300 N.W.2d 281, 287 (Iowa 1981). Several courts have extended accountants' liability to unknown but reasonably forseeable third parties who rely on negligently prepared financial statements. *See, e.g.*, Rosenblum v. Adler, 93 N.J. 324, 352, 461 A.2d 138, 153 (1983); International Mortgage Co. v. John P. Butler Accountancy Corp., 223 Cal. Rptr. 218 (Cal. App. 1986). Investment bankers would owe a duty to shareholders either under Section 552 of the Restatement or a liability to reasonably foreseeable third parties theory. For a discussion of accountants' liability to third parties, see Fiflis, *Current Problems of Accountants' Responsibilities to Third Parties*, 28 VAND. L. REV. 31, 67-87 (1975).

94. The investment banker arguably might owe a fiduciary duty to the shareholders. This theory, however, was rejected in Weinberger v. UOP, Inc., 426 A.2d 1333, 1348 (Del. Ch. 1981). ("[P]laintiff has offered no authority to indicate that an investment banking firm rendering a fairness opinion as to the terms of a merger owes the same fiduciary duty to the minority shareholders as does the majority shareholder."), *rev'd on other grounds*, 457 A.2d 701 (Del. 1983). *But see* Note, *The Standard of Care Required of an Investment Banker to Minority Shareholders in a Cash-out Merger:* Weinberger v. UOP, 8 DEL. J. CORP. L. 98, 119 (1983) (arguing that investment bank should owe fiduciary duty to shareholders when rendering fairness opinion).

95. This kind of categorization merely recognizes the intent of the corporation and investment bank in entering the contract for the fairness opinion. Indeed, the *Weinberger* court noted that UOP "retained the services of defendant Lehman Brothers for the purpose of rendering an opinion as to the fairness of the price to be paid the minority for their shares." 426 A.2d at 1338. Similarly, in *Joseph v. Shell Oil Co.*, Royal Dutch hired Morgan Stanley "to prepare an estimate of the value of the minority shares of Shell." 482 A.2d at 339.

96. In a withdrawn opinion in *Weinberger*, the Delaware Supreme Court narrowly construed the contractual obligations of an investment bank in rendering a fairness opinion, holding that:

> The contract obviously created a duty, including duty to the minority, but there is no basis for liability in the present record . . . . Lehman Brothers was employed to render a fairness opinion for the immediate benefit of the members of UOP's Board of Directors who were scheduled to meet five days from the date of employment. The working team submitted its report to the Board within the time alloted, thereupon fulfilling its duties and obligations under the agreed upon contractual terms.

Weinberger v. UOP, Inc., No. 58,1981, slip op. at 3 (Del. Feb. 9, 1982), *withdrawn*, 457 A.2d 701 (Del. 1983). In dissent, Justice Duffy argued that "Lehman Brothers had a duty to excercise reasonable care or competence in obtaining or communicating the information as to the value of the UOP shares . . . ; any failure to perform in accordance with that standard would make Lehman Brothers liable to the public shareholders for negligent misrepresentation." *Id.* at 7-8 (Duffy, J. dissenting). On the Duffy dissent, see Deutsch, Weinberger v. UOP*: Analysis of a Dissent*, 6 CORP. L. REV. 29

B. *A Procedural Standard of Care*

One argument against imposing liability on investment bankers for negligently prepared fairness opinions is that a workable standard of care cannot be developed. Courts appear concerned that diffuse and potentially costly duties will unduly burden investment bankers.[97] Opponents of expanded accountants' liability expressed similar fears.[98] Over time, however, accountants have responded to increased legal liability by improving their standards and techniques.[99]

In other corporate contexts, established practices frame workable legal norms. For example, the "reasonable investigation" that underwriters must perform prior to distributing securities pursuant to Section 11 of the 1933 Securities Act[100] has been honed into "model" verification procedures.[101] Courts have imposed Section 11 liability only for ignoring such conventional procedures as examining corporate minutes and material contracts.[102] Similarly, an accountant's compliance with generally accepted accounting standards is evidence of reasonable care.[103] This approach of consulting existing business conventions should be followed to determine liability for fairness opinions.

Investment bankers have not established industry guidelines for rendering fairness opinions. Nevertheless, there are certain widely shared practices that can provide the basis for imposing liability. Almost without exception, investment bankers perform some derivation of discounted cash flow (DCF) analysis, which calculates the net present value of the cash flows generated from ownership of the business entity.[104] In conjunction

(1983). Prior to the Delaware Supreme Court's second opinion, plaintiff dismissed Lehman Brothers from the action, thereby precluding consideration of an investment banker's obligation to minority shareholders when rendering a fairness opinion. 457 A.2d at 703 n.3.

97. *See* Anderson v. Boothe, 103 F.R.D. 430, 441 (D. Minn. 1984); Weinberger v. UOP, Inc., 426 A.2d 1333, 1348 (Del. Ch. 1981).

98. In Ultramares Corp. v. Touche, Niven & Co., 255 N.Y. 170 (1931), Judge Cardozo argued: "If liability for negligence [to third parties] exists, a thoughtless slip or blunder . . . may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class." *Id.* at 179.

99. *See* Mess, *Accountants and the Common Law: Liability to Third Parties*, 52 NOTRE DAME LAW. 838, 855-57 (1977) (discussing positive impact of increased accountants' liability).

100. 15 U.S.C. § 77k (1982).

101. Kraakman, *Gatekeepers*, *supra* note 9, at 83; *see also* Darrow & Sobel, *Underwriters' Due Diligence*, in PRACTISING LAW INSTITUTE, MECHANICS OF UNDERWRITING 1983, at 423, 462-86 (Corporate Law and Practice Course Handbook Series No. 433, 1983) (listing over fifty discrete steps in "reasonable" due diligence examination, beginning with check on issuer's credit and reputation and concluding with site visits to issuer's major properties).

102. Escott v. Barchris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968) (finding investment bankers, senior officers, outside directors, and accountant jointly and severally liable for investor losses on misleading registration statement).

103. *See* SEC v. Arthur Young & Co., 590 F.2d 785, 787-89 (9th Cir. 1979) (accountant's adherence to generally accepted accounting standards held to discharge obligation).

104. *See* Saffer, *Touching All Bases in Setting Merger Prices*, MERGERS & ACQUISITIONS, Fall 1984, at 42; Harris, *supra* note 18, at 151-59. There are four basic steps in a DCF valuation: (1)

with DCF analysis, most investment bankers use three other kinds of analyses to prepare fairness opinions: evaluation of comparable acquisitions, comparison with comparable companies and liquidation analysis.[105] The comparable acquisitions method of valuation entails an analysis of the prices paid in transactions for companies comparable to the business under consideration.[106] An examination of the financial ratios of companies comparable to the business being valued provides useful benchmark data.[107] A liquidation analysis is simply a valuation of the discrete units of a business, assuming that the business will be sold in separate pieces rather than as one unit.[108]

Often, the reason a fairness opinion is poorly prepared is that the investment banker relied solely on one valuation technique.[109] If, for example, an investment banker does not measure the liquidation value of a business, and liquidation value is higher than going-concern value, the fairness opinion may be flawed.[110] Similarly, when investment bankers fail to consider comparable acquisitions, the fairness opinion may not accurately reflect market demand. In a going-private transaction involving management or a cashout merger, this omission might mean that share-

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projection of the earnings and cash flow of the business for a period of five to ten years; (2) determination of the value of the business at the end of the projection period; (3) determination of the risk characteristics of the business and the appropriate discount rate; and (4) the actual calculation of the DCF values. *See generally* R. Brealey & S. Myers, Principles of Corporate Finance 70-78, 85-93, 164-78 (2d ed. 1984) (discussing mechanics of DCF valuation).

105. *See* Harris, *supra* note 18, at 150; Saffer, *supra* note 104, at 42-43; Bernstein, *Considerations in Rendering Fairness Opinions in Going Private Transactions*, in Practising Law Institute, Going Private 1981, at 343, 345-46 (Corporate Law and Practice Course Handbook Series No. 370, 1981).

106. The comparable acquisitions method of valuation presumes that there is a "market" price that will be paid for firms in a given industry. A company in a high growth industry, for example, might be expected to command a higher price relative to its net income and book value than would a company in a industry with slower growth rates in revenues and earnings. An analysis of comparable acquisitions generally includes the purchase price in each transaction as a multiple of sales, net income, book value and operating cash flow as well as premiums over market price. *See* Harris, *supra* note 18, at 167-69; Saffer, *supra* note 104, at 43-45.

107. There are four types of financial ratios: leverage ratios, liquidity ratios, profitability or efficiency ratios, and market value ratios. For discussion of the use of financial ratios in analyzing the financial performance of companies, see R. Brealey & S. Myers, *supra* note 104, at 569-87; Harris, *supra* note 18, at 159-67.

108. Liquidation analysis involves the valuation of the operating entities of the firm using DCF analysis, comparable acquisitions and comparable companies. Corporate debt not assigned to any operating division is subtracted at its market value. Investments (e.g., marketable securities, equity holdings, joint ventures and real estate) are valued at market value and added to determine liquidation value. Such analysis also should include the value of intangible assets such as patents and trademarks, technological skills, subscriber lists and other proprietary information. Liquidation analysis is particularly useful when the company being valued operates across several industries and/or has many hidden assets which do not appear on the books of the business.

109. *See, e.g.*, Saffer, *supra* note 104, at 43-45 (discussing limits of DCF); *Longstreth, Now Private Citizen, Calls for Reform in Leveraged Buyouts*, 16 Sec. Reg. & L. Rep. (CCH) 641, 641 (1984) (discussing failure to examine comparable acquisitions and liquidation).

110. *See* V. Brudney & M. Chirelstein, Cases and Materials on Corporate Finance 16-28 (2d ed. 1979).

holders receive far less than what an outside party would pay for the firm.[111]

When applying these four valuation techniques, an investment banker can make a number of errors. First, the investment banker might make a purely computational error that affects the accuracy of the opinion. Second, the investment banker could select a discount rate or financial ratio that is unduly high or low for a firm in a particular industry. Third, the financial projections might be too optimistic or pessimistic.[112] Finally, the investment banker might fail to update existing valuation data.[113]

The selection of discount rates, financial ratios and financial projections, although a subjective process, is governed by certain rules.[114] Courts should require that investment bankers justify the selection of such values when they are not within a reasonable range. Similarly, investment bankers should have some responsibility to examine the reasonableness and accuracy of financial information used in opinions.[115]

Courts should impose liability on investment bankers when a fairness opinion has not been based on a valuation conforming to accepted standards in the investment banking industry. In making this determination, courts should engage in a fact-finding process similar to that followed in cases involving accountants' negligence.[116] The definition of what constitutes an acceptable valuation should be broad. In general, liability should be imposed when investment bankers do not properly follow all four accepted valuation techniques. There may be cases, however, where investment bankers can reasonably justify the use of only some of these techniques.[117] Courts also must recognize that the development of valuation techniques is not a static process, and that more advanced techniques will become widely accepted in the future.[118]

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111. *See* Saffer, *supra* note 104, at 43-44.

112. On the problems of error and bias in financial projections, see R. BREALEY & S. MEYERS, *supra* note 104, at 222-24.

113. *See* Chazen, *supra* note 4, at 1463-65 (discussing importance of timing in rendering fairness opinions).

114. *See* R. BREALEY & S. MYERS, *supra* note 104, at 173-78 (discount rates), 569-80 (financial ratios), 224-34 (financial projections); Harris, *supra* note 18, at 151-59.

115. *See* Feuerstein, *supra* note 4, at 1339 (defining "reasonable investigation").

116. *See* Fiflis, *supra* note 93, at 62-87.

117. *See* Harris, *supra* note 18, at 150 (discussing usefulness of different valuation procedures).

118. *See, e.g.*, Ross, *The Arbitrage Theory of Capital Asset Pricing*, 13 J. ECON. THEORY 341 (1976) (proposing new model for measuring expected returns on assets).

IV. STRICTER JUDICIAL SCRUTINY OF FAIRNESS OPINIONS IN PRACTICE

A. *Directors' Reliance*

Stricter judicial scrutiny of directors' reliance on fairness opinions will not be costless. An increase in the likelihood that directors will be sued and held personally liable for damages could reduce the number of value-increasing corporate control transactions.[119] When directors do enter into such transactions, they may overinvest in information and follow time-consuming procedures.[120]

These possible costs are outweighed by important benefits. First, increased judicial scrutiny will improve the quality of fairness opinions. Fairness opinions of high quality will in turn reduce directors' opportunism both in pursuing and opposing transactions. For example, such opinions can deter directors from making acquisitions that increase firm size but not profits, and provide protection to minority shareholders in such freezeout transactions as a leveraged buyout involving management or a cashout merger of a subsidiary by the parent corporation. Similarly, carefully prepared opinions can prevent the directors of target firms from adopting costly defensive tactics that stop value-increasing transactions. The absence of a large market for shares makes fairness opinions of quality particularly beneficial in transactions involving closely held corporations.

B. *Investment Bankers' Liability*

If investment bankers are liable for negligent fairness opinions, they are likely to demand indemnification or charge large risk premiums.[121] Even if investment bankers are indemnified, however, liability will encourage them to render opinions with greater diligence. First, corporations probably will not fully indemnify investment bankers[122] and some may not in-

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119. Corporate directors cannot diversify the value of their human capital and thus have a tendency to avoid risk. If directors are sued whenever a corporate control transaction turns out poorly, they will have an incentive to avoid such transactions. The ability of directors to shift their personal risks through indemnification or insurance, however, reduces this agency problem. *See* Kraakman, *Corporate Liability Strategies*, *supra* note 9, at 864-67. Similar protection is provided by charter provisions limiting director liability for duty of care violations. *See supra* note 71.

120. *See* Fischel, *supra* note 7, at 1446-47 (arguing that fairness opinions do not presently provide valuable information to directors). Once investment bankers face liability, however, the informational benefits of fairness opinions should increase.

121. *See* Kraakman, *Corporate Liability Strategies*, *supra* note 9, at 892.

122. Investment bankers typically are indemnified when rendering fairness opinions. The extent of such indemnification, however, is an important point of negotiation between the company and its investment bank. Often, the engagement letter does not provide for indemnification when the investment banker is negligent. *See* 2 M. LIPTON & E. STEINBERGER, TAKEOVERS AND FREEZEOUTS C-18 (2d ed. 1984) (sample indemnification agreement).

demnify them at all.[123] Second, if investment bankers are indemnified, those with reputations for rendering quality opinions will be most in demand. In other words, liability will improve market controls on investment bankers.[124]

Legal liability may strengthen the market position of the leading investment banks. Since these firms have established reputations and sophisticated staffs, there should be increased demand for their services. The leading investment banks are more likely to render impartial opinions than firms with less diversified client bases and smaller investments in reputation.[125]

V. Conclusion

Fairness opinions rendered by investment bankers play an important role in the process and documentation of corporate decisionmaking. Stricter judicial scrutiny of fairness opinions will promote development of more uniform, higher-quality valuation procedures and thus reduce management opportunism in corporate control transactions. Courts should confine their review of the quality of fairness opinions to whether directors and investment bankers follow proper procedures.[126] This kind of limited review is within judicial competence and would not unduly burden directors and investment bankers.

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123. *Cf.* Globus v. Law Research Serv., 418 F.2d 1276, 1287-89 (2d Cir. 1969) (denying indemnification to investment banker for Section 11 liability), *cert. denied*, 397 U.S. 913 (1970). Insurance against Section 11 liability is available for directors, accountants and lawyers. However, underwriter insurance has not been available since 1973. Banhoff, *Regulatory Subsidies, Efficient Markets and Shelf Registration: An Analysis of Rule 415*, 70 Va. L. Rev. 135, 181 n.220 (1984).

124. *See* Kraakman, *Gatekeepers*, *supra* note 9, at 96-100 (discussing limits of reputational controls).

125. *See id.* at 69-72 (discussing corruption of third-party monitors).

126. For example, if courts routinely evaluated the fairness of the price contained in the opinion, directors and investment bankers would have to meet an unreasonable standard of care. There might be rare cases, however, where a transaction is plainly unfair, even though the fairness opinion conforms to accepted standards. In such cases, courts should not permit directors to rely on the fairness opinion. *See supra* notes 88-89 and accompanying text.